

Rent-a-Captive Taxes Demystified

by Robert M. Horkovich

Captive insurance companies are now popular for tax planning in addition to risk management. In response, the IRS has developed an increasingly sophisticated set of standards for determining what is insurance over the past few years. The latest development in the IRS' analytical framework for captives is Revenue Ruling 2008-8, which defines the tax treatment of "rent-a-captives," known officially as segregated cell captives. The ruling holds that if a rent-a-captive satisfies the tax requirements of an insurance company, it will be treated as a standalone insurance company despite its lack of separate legal status.

In a typical rent-a-captive structure, a sponsor forms a segregated account company (SAC) that consists of segregated cells. The SAC effectively leases each cell to a user to conduct insurance business within. The sponsor provides captive management services to the cell for a fee. Under applicable law, the cell has license to write related-party insurance risk or to reinsure unrelated risk. The SAC typically owns the cell's common voting stock, while the cell's user owns preferred stock. Preferred stock dividends track the cell's net income. Each cell's assets and liabilities are thus insulated from other cells and the sponsor.

The significance of Rev. Rul. 2008-8 comes in the creative planning alternatives that it makes possible. The rent-a-captive industry is growing quickly thanks to the lower administrative costs of "renting" a captive. The SAC, not the cells, incurs incorporation costs and audit fees (unless auditing at the

cell level is desired). The low cost structure may make it cost-effective to set up multiple commonly-managed rent-a-captives, each of which—with careful planning—may qualify for a small insurance company tax exemption in situations where the cells' owners or users are business associates or family members.

The tax treatment of cells had been ambiguous because cells merely had partial characteristics of corporate personhood. A cell executes contracts for its own account, has limited liability and has independent governance if the tenant tells the sponsor how to vote. Cells are not separate legal entities, however. They cannot exist independently of their sponsor. Cautious tax advisers steered clients away from rent-a-captives, fearing that the IRS could contradict whatever interpretation the client chose, whether it involved saying the "insurance company" at hand was the SAC or the cell or both.

Rev. Rul. 2008-8 ends this uncertainty by making the pivotal issue whether the cell's activity is self-insurance or real insurance. If self-insurance, then the user cannot deduct premiums paid to the cell nor defer recognition of income via preferred stock dividends. If real insurance, then the user is essentially the owner of a standalone captive insurance company.

Some captive advisers have celebrated Rev. Rul. 2008-8 as a bold, new interpretation from the IRS. But the interpretation is neither new nor bold. The better argument is that Rev. Rul. 2008-8 now formalizes the proper interpretation that always existed.

The ruling also effectively overturns the commonly held view that captive insurance tax elections (such as the section 953(d) "domestic" election) must be made by the SAC sponsor. Per IRS Notice 2008-19, such tax elections should be made at the cell level, provided that the cell meets the tax definitional requirements of "insurance."

Considering the importance of including a captive's insurance accounting methods in a corporate taxpayer's consolidated return, rent-a-captive cells remain an exception in corporate America because it is unclear whether a cell can be consolidated. A parent (and/or affiliates) must own 80% of a captive's stock by vote and value in order to consolidate it. Although a cell's preferred stockholder may be able to tell the sponsor how to vote, the sponsor retains voting control formally. Lingering ambiguities such as this reveal that Rev. Rul. 2008-8 is just a first step in guidance for this area. ■

